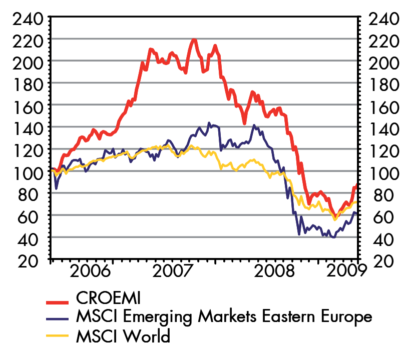
Strategy Croatia

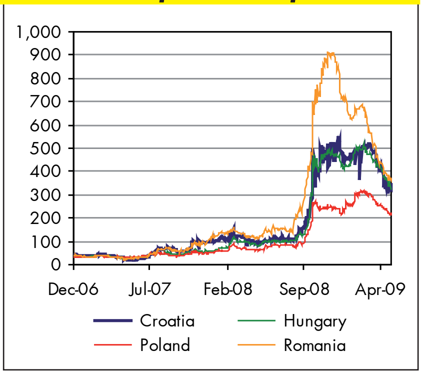
June 2009

Index performance



Source: Thomson Financial Datastream

Eurobond spreads (bp)



EUR EMBIG government spreads (bp)
Source: JP Morgan, Raiffeisen RESEARCH

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Highlights

- Personal consumption – the most important generator of GDP growth in previous years – will be negatively affected by declining employment, a fall in net salaries and curbed loans for personal spending. In these circumstances, only the softened negative influence of net exports will be able to make any degree of contribution to a milder decrease in GDP.

- Following its planned accession to the EU in 2012, Croatia is not expected to delay its accession to the Eurozone. Although solving the border dispute with Slovenia is currently seen as the largest hurdle, Croatia needs to press on with structural reforms in order to meet the framework for the closing of negotiations. Despite the great progress that has been made in the reform of the judiciary system, there is still a need for better implementation of the adopted reforms.

- By the end of May 2009 Croatia issued its first Eurobond since 2004. The expected volume of EUR 750 mn was reached, but the deal attracted commitments of about EUR 1.25 bn. The issue was priced at 360bp over mid-swap, with a maturity in January 2015. Although this issue might be seen as a successful return to the foreign capital markets, it is clear that the government will have higher financing needs for this year.

- The outflow of capital from the Zagreb Stock Exchange appears to have started losing momentum in March. After briefly trading at a five-year low, the CROEMI stock index has recently seen a substantial recovery. The Croatian equity market will also be pushed upwards in the course of a worldwide recovery. However, this is unlikely to be a one-way street to the top, as the global recession has now reached Croatia as well, which leads us to believe that the Zagreb Stock Exchange will experience a high level of volatility throughout the second half of the year.

Key economic figures and forecasts

	2004	2005	2006	2007	2008	2009e	2010f
Nominal GDP (EUR bn)	32.8	35.7	39.1	42.8	47.4	45.3	47.6
Real GDP (% yoy)	4.2	4.2	4.7	5.5	2.4	-4.5	0.4
Industrial output (% yoy)	3.7	5.1	4.5	5.6	1.6	-5.1	1.7
Unemployment rate (eop, %)	18.5	18.0	17.0	14.7	13.7	14.5	14.4
Nominal industrial wages (% yoy)	6.7	6.1	7.4	6.6	6.0	-1.2	3.1
Producer prices (avg, % yoy)	3.5	3.0	2.9	3.4	8.4	-0.4	4.0
Consumer prices (avg, % yoy)	2.1	3.3	3.2	2.9	6.1	3.2	4.4
Consumer prices (eop, % yoy)	2.7	3.6	2.0	5.8	2.9	4.2	4.3
General budget balance (% of GDP)	-4.8	-4.0	-3.0	-2.3	-2.4	-3.4	-2.5
Public debt (% of GDP)	51.6	52.2	49.6	47.6	46.4	47.5	48.0
Current account balance (% of GDP)	-4.4	-5.5	-6.9	-7.6	-9.4	-6.7	-7.9
Official FX reserves (EUR bn)	6.4	7.4	8.7	9.3	9.1	8.1	8.9
Gross foreign debt (% of GDP)	70.0	72.1	74.9	77.6	83.0	90.2	88.2
EUR/HRK (avg)	7.50	7.40	7.32	7.34	7.22	7.46	7.55
USD/HRK (avg)	6.03	5.95	5.81	5.35	4.91	5.25	5.21
EUR/USD (avg)	1.24	1.24	1.26	1.37	1.47	1.42	1.45

Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

Raiffeisen RESEARCH
RZB Group

Strategy Croatia
Content

The greatest challenges lie ahead

After recording the weakest growth for the domestic economy over the past decade in 2008, Croatia saw a further deterioration in economic conditions at the beginning of this year. Industrial production and retail trade declined at double-digit rates, which interrupted the trend of declining unemployment that had lasted for years. Unfortunately, the period ahead will not bring many reasons for optimism. The crisis in the world's most developed countries is more complex and pronounced than previously anticipated and consequently requires additional efforts from economic policymakers aimed at reversing the trend in the global economy. In addition to economic contraction itself and the resulting decline in the standard of living for households, Croatia, as other developing countries, is faced with the danger of instability in the domestic currency and the financial system as a result of external imbalances that have persisted for years. In these circumstances there is little room for expansive monetary policy in reaction to the decline in economic activity. In addition, the possibilities of anticyclical effects of fiscal policy are fairly limited due to the unfavourable structure and volume of public spending, primarily as a consequence of a failure to implement major reforms over the past several years. The unfavourable structure of government expenditures make it impossible to adjust to the new economic situation in the short term, which is also being reflected in a substantial reduction of budget revenues. As there is only limited access to foreign sources of capital, the government satisfied most of its needs in the domestic capital market. However, this method of financing this year's deficit against an extremely restrictive monetary policy has led to a rise in interest rates, as would be expected. If this trend continues, it is likely that the private sector will be pushed away from the source of capital, which will greatly weaken Croatia's economic potential in the future.

It is hard to tell when Croatia will pull out of this recession considering all of the current uncertainties. However, a recovery is only likely to come after activity in the Eurozone intensifies and international capital flows return to normal conditions, at least partially. The failure to implement structural reforms poses an additional burden on the domestic economy in these turbulent times. It is growing more and more likely that these moves will have to be made in a much more unfavourable economic environment, which will make even the short-term negative impacts more pronounced. The issue of strategy and Croatia's long-term sustainable growth still remains open.

Main political parties in Parliament

Ruling coalition	*Party leader*	*Orientation*
Croatian Democratic Union (HDZ)	Ivo Sanader	Center-right
Croatian Peasant Party (HSS)	Josip Friščić	Center
Independent Democratic Serbian Party (SDDS)	Milorad Pupavac	Minority
Croatian Social Liberal Party (HSLS)	Đurđa Adlešić	Center-left
Croatian Party of Pensioners (HSU)	Silvano Hrelja	Center
Opposition Parties		
Socialdemocratic Party (SDP)	Zoran Milanović	Center-left
Croatian People's Party - Liberal Democrats (HSLS)	Radimir Čačić	Center
Croatian Democratic Alliance of Slavonia and Baranja (HDSSB)	Vladimir Šišljagić	Right
Istrian Democratic Assembly (IDS)	Ivan Jakovčić	Center-left
Croatian Party of Rights (HSP)	Anto Đapić	Right

Source: Political parties

Election schedule*

Presidental election	January 2010
Parliamentary elections	November 2011

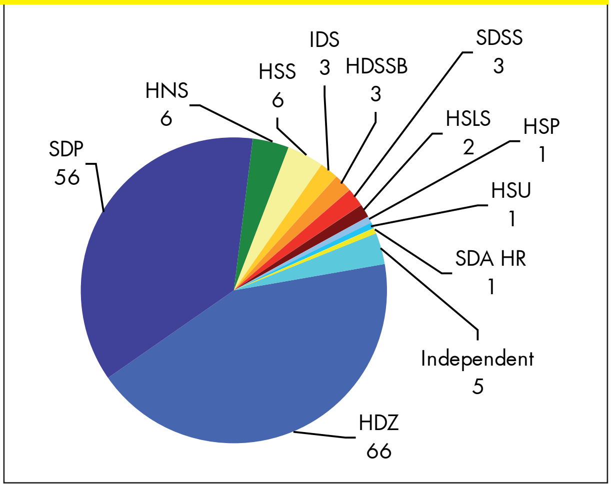
**president is elected for a term of five years, parliamentary members are elected for a four year term*
Source: Government

Ruling persons

Function	*Name*	*Party affiliation*
President of the Republic	Stjepan Mesić	
Prime Minister	Ivo Sanader	HDZ
Speaker of the Parliament	Luka Bebić	HDZ

Source: Government, Parliament, Office of the President

Seats in the Parliament



Source: Croatian Parliament

On the road again?

Key dates in Croatia's path towards the EU

June 2000	The Feira European Council states that all the SAP countries are "potential candidates" for EU membership.
November 2000	Zagreb Summit launches the Stabilisation and Association Process (SAP) for five countries of South Eastern Europe, including Croatia
29 October 2001	Stabilisation and Association Agreement signed
21 February 2003	Croatia applies for EU membership
June 2003	Thessaloniki European Council confirms accession perspective of Western Balkans countries, including Croatia
April 2004	European Commission issues positive opinion on Croatia's application for EU membership application
June 2004	European Council confirms Croatia as candidate country
December 2004	European Council sets 17 March 2005 as start date for negotiations conditional upon full cooperation with the International Criminal Tribunal for the former Yugoslavia
01 February 2005	Stabilisation and Association Agreement (SAA) enters into force
16 March 2005	EU postpones start of accession negotiations but adopts framework for negotiations with Croatia
26 April 2005	First meeting of Stabilisation and Association Council; meeting of extended "EU troika" on Croatia's cooperation with the ICTY
03 October 2005	International Criminal Tribunal for the former Yugoslavia (ICTY) Chief Prosecutor assesses Croatia is now fully cooperating with ICTY. Council concludes last remaining condition for starting negotiations is met. Accession negotiations are launched the same day.
20 October 2005	'Screening' stage of accession negotiations begins.
12 June 2006	First chapter of the accession negotiations - science and research - formally opened and provisionally closed at an Accession Conference (ministerial level).
18 October 2006	Screening' concluded; accession negotiations continue.
12 February 2008	The Council adopts the new Accession Partnership
30 October 2008	7th meeting of the Accession Conference at Deputy Level sees number of negotiation chapters provisionally closed reach four. 21 chapters have been opened so far.

Source: European Commission

The intergovernmental conference on Croatia's accession to the EU was scheduled for 27 March 2009. However, the Czech Presidency of the European Union postponed the conference until 24 April, expecting that progress regarding Slovenia's veto would be made by then. It remained uncertain whether the intergovernmental accession conference would actually take place on 24 April up until the very last moment, and even if it did it was not expected that many chapters would be opened or closed. Ultimately, the conference was again postponed until May 2009.

Negotiations are currently open on 22 out of 35 chapters. Seven chapters have been provisionally closed, Chapter 7 – Intellectual Property Law, Chapter 10 – Information Society and Media, Chapter 17 – Economic and Monetary Policy, Chapter 20 – Enterprise and Industrial Policy, Chapter 25 – Science and Research, Chapter 26 – Education and Culture, and Chapter 30 – External Relations. Up to now, Croatia has adopted and submitted 31 negotiating positions and needs to submit two more: Chapter 8 – Competition Policy and Chapter 23 – Judiciary and Fundamental Rights.

In the middle of March 2009, the European Parliament adopted a resolution on Croatia's 2008 progress report in a majority vote. This resolution states that EU mediation in the resolution of the border dispute between Croatia and Slovenia should be based on international law. The final version differs from the previous version in that it does not mention the International Court of Justice in The Hague, but an "international body". The adopted resolution expresses confidence "that the goal of concluding negotiations in accordance with the indicative road map published by the Commission can be achieved, provided that the Government of Croatia steps up its efforts to address particularly the more sensitive issues linked to the accession process, including fighting organised crime and corruption, and finally meets the benchmarks in these areas, and also provided the Council is willing and able to open all negotiation chapters without further delay".

In the middle of April, Croatia submitted its response to the proposal by EU Enlargement Commissioner Olli Rehn for the resolution of the border dispute with Slovenia and the continuation of Croatia's accession negotiations. Croatia's proposal is based on three principles – the consideration of the dispute separately from Croatia's EU integration process, continuation, i.e. the prompt deblocking of Croatia's negotiations and a resolution of the border dispute in accordance with international law before an international judiciary body.

At the last meeting held in Brussels at the end of April, after considering the Croatian and Slovene responses to the initial proposal for the resolution of the countries' border dispute, EU Enlargement Commissioner Rehn presented his latest proposal aimed at solving the dispute. According to his latest proposal, the border dispute between Croatia and Slovenia regarding the common land and sea border should be solved via a five-member international arbitration tribunal that would operate in accordance with international law. Croatia and Slovenia would each name one of the five members of the panel and choose the remaining three members by consensus. If the two countries are unable to reach an agreement, the remaining three members would be chosen by the president of the International Court of Justice. The issues of the use of the sea and Slovenia's contact with the open seas would be defined in accordance with international law, but also good neighbourly relations and the principle of justice. Should they fail to agree, this would be done by the arbitration court.

In addition, the proposal envisages the deblocking of Croatia's EU accession negotiations immediately after the two parliaments ratify the agreement on the resolution of the border dispute at an arbitration court. In order to ensure that the ratification process is not dragged out, Croatia and Slovenia should commit to speedy ratification by their parliaments when signing the agreement. The EU presidency trio of France, the Czech Republic and Sweden expressed their support for Rehn's latest proposal. Croatia has accepted the proposal. Slovenia has a number of amendments. Details have not been made public yet. A large number of chapters could be opened and closed at Croatia's accession conference in May.

Following its planned accession to the EU in 2012, Croatia is not expected to delay its accession to the Eurozone. Although solving the border dispute with Slovenia is currently seen as the largest hurdle, Croatia needs to press on with structural reforms in order to meet the framework for the closing of negotiations. Despite the great progress that has been made in the reform of the judiciary system, there is still a need for better implementation of the adopted reforms. There are also still the issues of shipbuilding and agricultural reform that must be resolved as an eligibility requirement for accession.

Chapters of the acquis communautaire

		Progress
1	Free Movement of Goods	open
2	Freedom of Movement for Workers	open
3	Right of Establishment and Freedom to provide Services	open
4	Free Movement of Capital	
5	Public Procurement	open
6	Company Law	open
7	Intellectual Property Law	provisionally closed
8	Competition Policy	
9	Financial Services	open
10	Information Society and Media	provisionally closed
11	Agriculture and Rural Development	
12	Food safety,Veterinary and Phytosanitary Policy	
13	Fisheries	
14	Transport Policy	open
15	Energy	open
16	Taxation	
17	Economic and Monetary Policy	provisionally closed
18	Statistics	open
19	Social Policy and Employment	open
20	Enterprise and Industrial Policy	provisionally closed
21	Trans-European Networks	open
22	Regional Policy and Coordination of Structural Instruments	
23	Judiciary and Fundamental Rights	
24	Justice, Freedom and Security	
25	Science and Research	provisionally closed
26	Education and Culture	provisionally closed
27	Environment	
28	Consumer and Health Protection	open
29	Customs Union	open
30	External Relations	provisionally closed
31	Foreign, Security and Defence Policy	
32	Financial Control	open
33	Financial and Budgetary Provisions	open
34	Institutions	
35	Other Issues	

Source: MFAEI, Raiffeisen Consulting

Financial allocation (EUR mn)

	2007	2008	2009	2010
IPA programme by component				
Assistance in transition and institution building	49.60	45.40	45.60	39.50
Cross border cooperation	9.70	14.70	15.90	16.20
Regional development	45.05	47.60	49.70	56.80
Human resources development	11.38	12.70	14.20	15.70
Rural development	25.50	25.60	25.80	26.00
Total	141.23	146.00	151.20	154.20

Source: CODEF

Croatia
A short overview

Structural information

Land area	56.594 square km
Population	4,437,460 (2001)
Capital city	Zagreb
Fiscal year	1 Jan - 31 Dec
Currency	Kuna (HRK)

Source: Croatian National Bank, CBS

Foreign currency rating

Agency	*Long-term*	*Short-term*
Standard & Poor's	BBB	A-3
Moodys	Baa3	not rated
Fitch IBCA	BBB-	F3

Source: CBS

Major cities (population 2001)

Zagreb	779,145
Split	188,694
Rijeka	144,043
Osijek	114,616
Zadar	72,718
Sl. Brod	64,612
Karlovac	59,395
Pula	58,594
Sisak	52,236
Šibenik	51,533
Varazdin	49,075

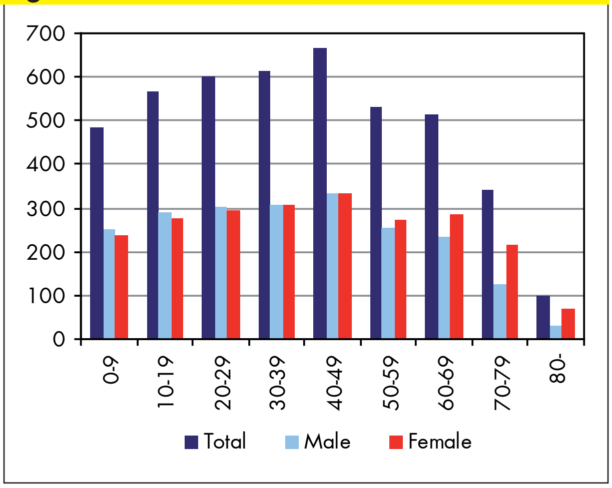
Source: CBS

GDP 2008

Current prices (EUR mn)	47,370
Per capita (EUR)	10,682
Real growth rate (%)	2.4

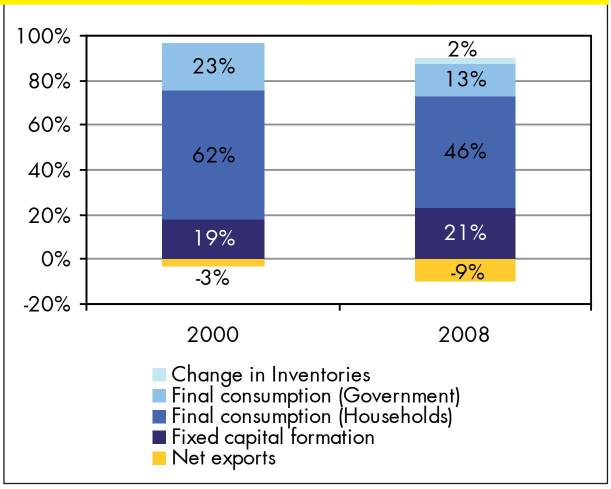
Source: CBS

Age distribution (2001)



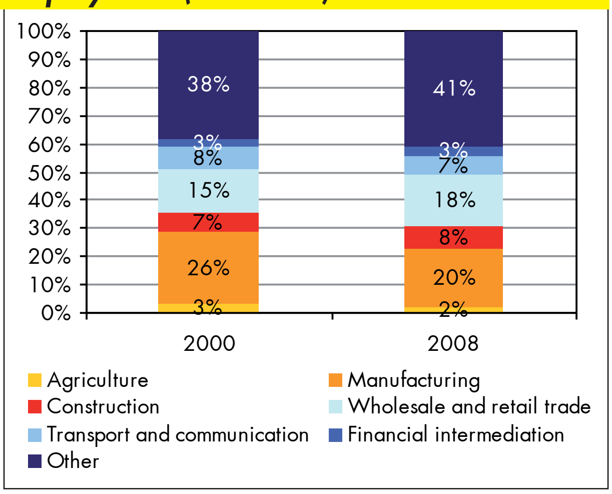
Source: CBS

Demand side of GDP (% share)



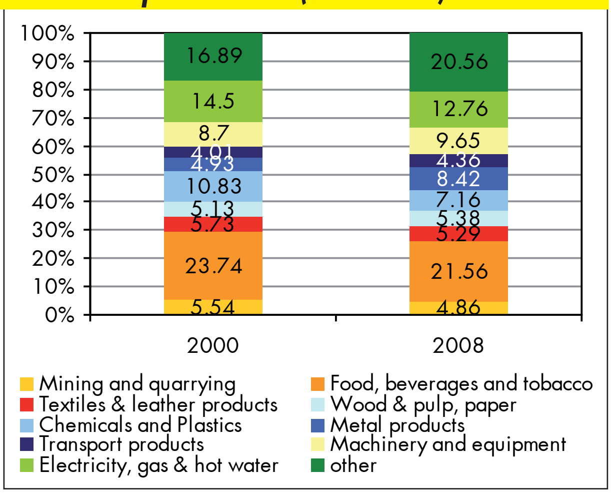
Source: CBS

Employment (% of total)



Source: CBS

Industrial production (% of total)



Source: CBS

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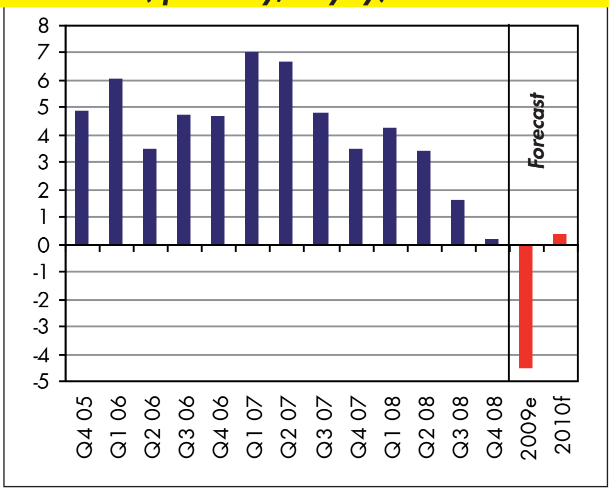
How to achieve sustainable economic growth?

Last year's end-of-year data have already demonstrated the unsustainability of the current economic development model of countries in the region, including Croatia. Although the domestic economy surprisingly did not contract in the last quarter of 2008, a decrease in GDP was avoided solely as a result of increased government spending and capital investments. However, government expenditures will have to be adjusted to the current state of the economy and 2009 is expected to see a drop in investments due to more difficult access to sources of funds. In the upcoming period, the government will have to redirect its limited means to areas which provide for larger and faster returns than current investments. Furthermore, personal consumption – the most important generator of GDP growth in previous years – will be negatively affected by declining employment, a fall in net salaries and curbed loans for personal spending. In these circumstances, only the softened negative influence of net exports will be able to make any degree of contribution to a milder decrease in GDP. A relatively optimistic scenario, which envisages a recovery of the euro area economy in late 2009, indicates a possibility of more favourable developments in the domestic economy in the second half of next year. While growth rates of 4–5% were seen as a "failure" not so long ago, it will be hard to return to such GDP growth rates in the medium term.

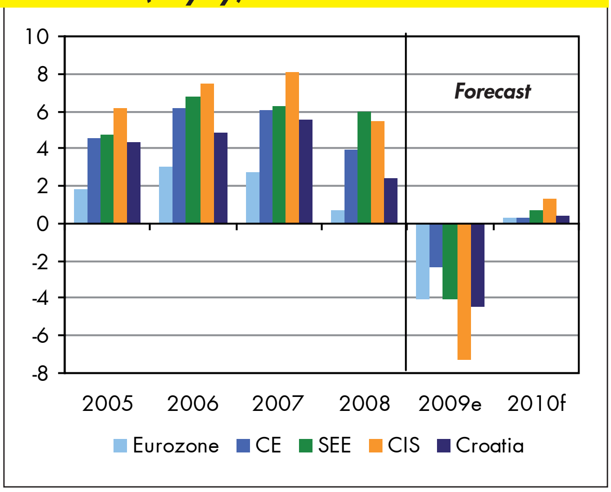
Inflationary pressures in Croatia started slackening with the decline in the prices of energy and food products in the second half of 2009. However, the upward pressure on consumer prices again intensified in the beginning of 2009. This was primarily a result of the rise in administratively determined prices, such as the price of healthcare and heating. This year also showed that weaker consumption is reflected in the movement of prices much slower than in developed economies, which confirms the claim that a substantial share of the inflationary pressure in Croatia continues to be of a structural nature. Despite this, the drop in goods and services at the global and domestic level should result in noticeably lower average inflation in 2009 compared to the previous year. Assuming that the world's largest economies recover by the end of this year, accompanied by price growth for energy and raw materials, and as a result of slightly slower price growth in the Republic of Croatia in the last quarter of the previous year, we could see the growth rate for consumer prices increase slightly again at the end of 2009.

Real GDP (quarterly, % yoy)



Source: CBS, Raiffeisen RESEARCH

Real GDP (% yoy)



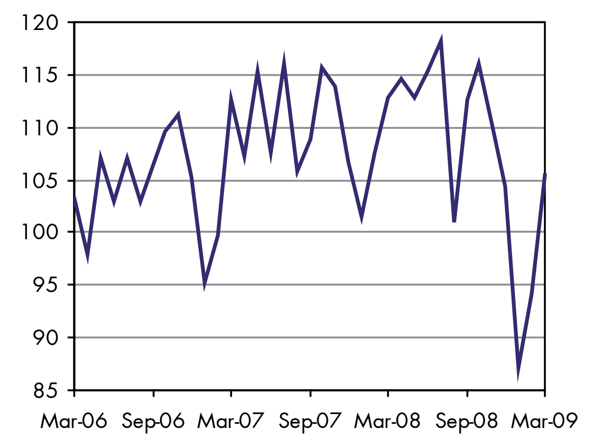
Sources: wiiw, Raiffeisen RESEARCH

Consumer prices (% yoy)

Source: CBS

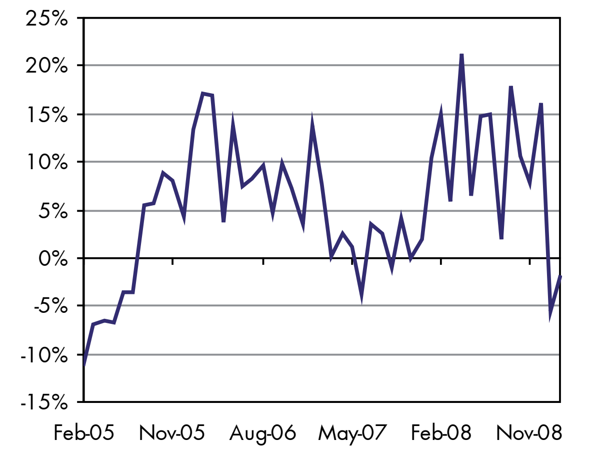
Unemployment increases again?

Basic indicies of industrial production*



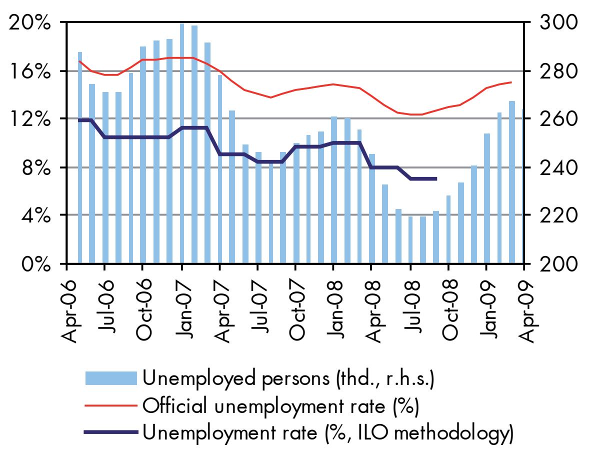
* 2005=100
Source: CBS

Construction (% yoy)



Source: CBS

Unemployment



Source: CBS, CES

The beginning of this year saw a dramatic contraction in industrial production. In addition to a reduction in both domestic and external demand, this contraction came as a result of restrictions on the gas supply for economic entities. The decline in production was only slightly mitigated by continuing favourable trends in the energy production segment amid inelastic demand for these goods and a cold winter. Although it may be expected that the negative trends in industry will improve somewhat at the end of the year, the decline in industrial production for this year could exceed 5%. With such an outlook, it is expected that the number of employed persons and productivity in industry will continue to fall. A temporary crisis will result in substantial structural changes in domestic industry. In the upcoming period it is likely that capacity and employment will substantially decrease in work-intensive sectors with steep international competition in the price segment, such as the shipbuilding, textile and wood processing industries. It is questionable whether these industry segments will ever completely recover. Therefore, it is necessary to redefine the system of government aid, which should serve only as an economic policy instrument, meaning that it should be primarily directed at the most promising sectors in the long term. At the same time, it is important to set the goals and the duration of government aid in a way that does not jeopardise market mechanisms.

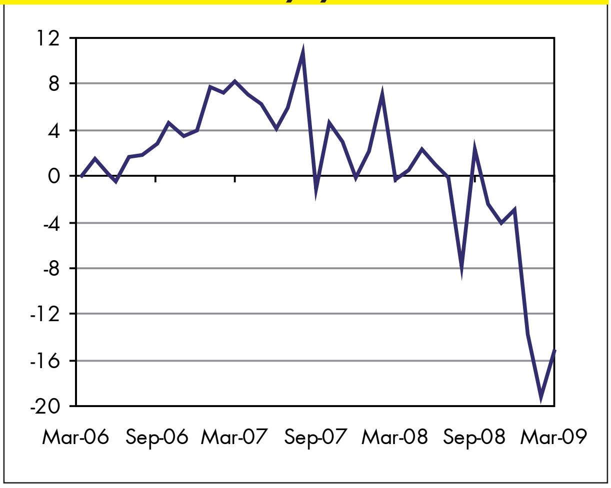
In the first quarter of the year, the long-time trend of decreasing unemployment was interrupted as a result of weakening activity in the real sector. In addition, it is evident that the favourable influences of seasonal economic developments on the domestic labour market will be less prominent and start later than in previous years, primarily due to expected unfavourable trends in the processing, construction and tourism industries. This year we expect to see a more pronounced rise in both registered and survey unemployment. In addition to increasing unemployment, there is also considerable risk related to a portion of the labour force becoming inactive. The rise in unemployment will probably result in a reduction of salaries this year, at least in the private sector. More favourable trends in the domestic labour market are only likely to be seen again following a recovery in the real sector and even then only after a certain delay. In such circumstances, there is an increasing need for the introduction of new employment measures, especially with regard to education and retraining, so that the labour force can accommodate rapid shifts in the structure of the economy.

Facing challenges

The beginning of 2009 was marked by a significant decline in retail turnover, with the fall in demand being most visible in the sale of durable goods, such as motor vehicles and furniture. Although the decline at the beginning of this year was to a large extent a result of the prohibition of stores being open on Sundays, it is evident that this year will see a substantial decline in retail trade. The expected fall in employment and the decline in net salaries, paired with slower growth of loans for consumer spending, will continue to contribute to a decline in personal consumption. Optimism is currently very low among domestic producers and, in combination with the crisis in the real economy, negative trends in the domestic capital and real estate markets are having a negative influence on the perception of consumers with regard to their purchasing power. In addition to a pronounced decline in the number of workers in the trade sector, it is clear that the consolidation process has intensified as a reaction to the end of the long-standing trend of growth in this area. This will continue in the upcoming period through mergers and acquisitions and exits from the market on the part of less competitive and financially weaker players.

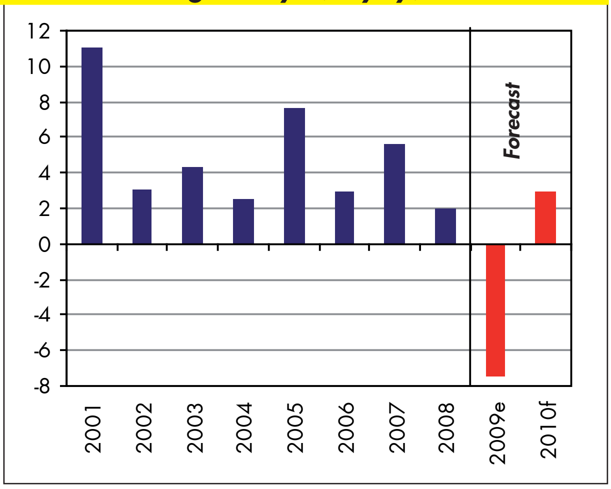
The tourism sector is faced with the most difficult season in the last decade, or more accurately since the Kosovo crisis. Preliminary data indicate considerable divergence in the estimates of this year's decrease in the number of tourist arrivals and overnight stays by foreign tourists, which is not unexpected considering the great uncertainty with regard to future global economic developments. However, the domestic tourism segment has certain comparative advantages in these circumstances, especially the proximity to the most important markets. Although tourists will probably cut their vacations short this year, we do not expect the decline in overnight stays to exceed single-digit levels. Nevertheless, revenues from tourism could fall more substantially. In addition to the previously mentioned negative influence on trade, reduced tourist spending will undoubtedly affect developments in the processing industry and the construction sector. As a result of the anticipated weaker business results this year, larger investments are not to be expected over the next year, although we have seen large investments in the expansion and improvement of accommodation capacity over the last year. We see long-term potential for tourism development in the widening of the services offered to tourists, investments in nautical tourism and the development of the image of individual destinations.

Retail trade (real, % yoy)



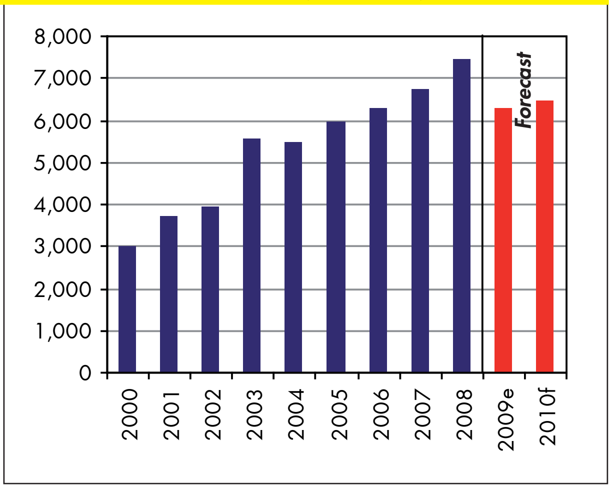
Source: CBS

Tourist overnight stays (% yoy)



Source: CBS

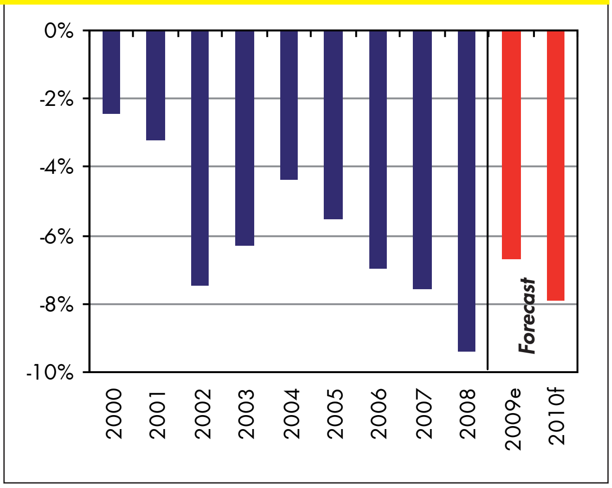
Revenues from travel (EUR mn)



Source: CNB, CNTB

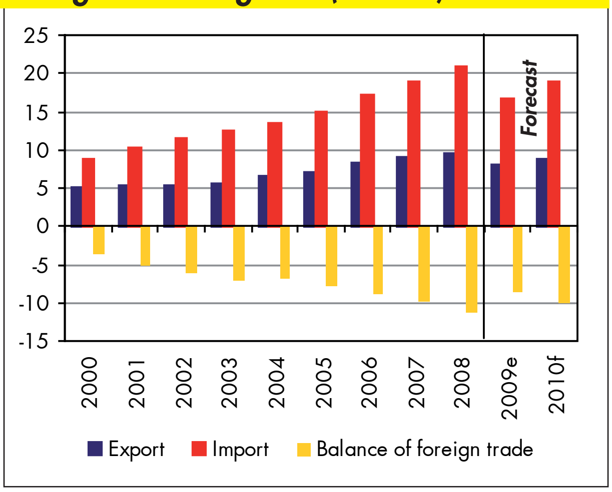
Difficult financing
of external imbalance

Current account balance (% of GDP)



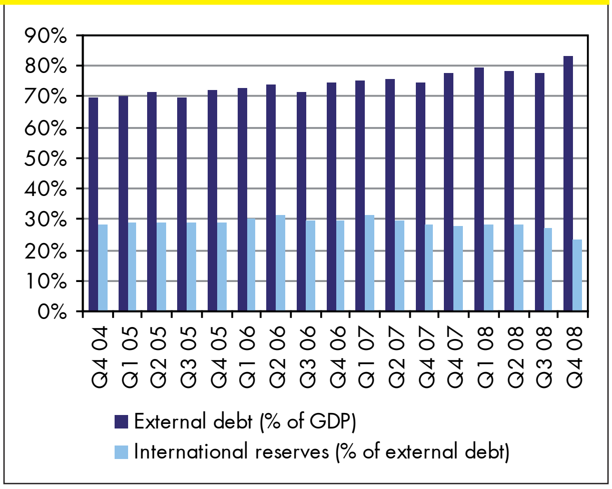
Source: CNB

Foreign trade of goods (EUR bn)



Source: CNB

External debt



Source: CNB

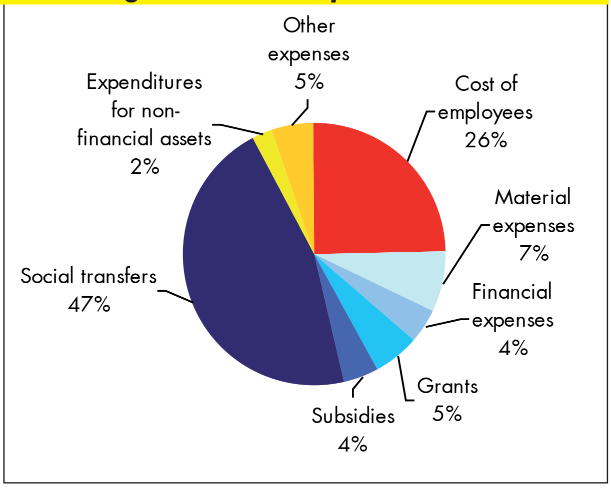
Last year saw strong growth in the current transactions deficit, with the largest contribution coming from the growth of the external trade deficit due to the rise in energy and raw materials prices experienced last year. Not even the continued surplus growth in the services account was able to reduce the upward pressure on the current account deficit. In 2009, we expect the observed deficit to decrease both in absolute and in relative terms. The decline in domestic demand paired with continued low prices on the world's commodities exchanges should result in a lower external trade deficit. However, the likely fall in revenues from tourism could have an unfavourable influence on developments in the current transactions account. At the same time, the rise in expenses from foreign borrowing combined with the expected increase in the outflow of profit suggests that the growth of the income account deficit will continue. Despite the expected reduction in the current transactions deficit, this year will quite possibly see the worst circumstances for its financing. This year, external debt is likely to grow more slowly, while the inflow of foreign direct investments will be substantially less than in previous years. Under such circumstances, the Republic of Croatia's foreign reserves will be placed under increased pressure.

The end of last year saw the usual growth of the Republic of Croatia's external debt. However, changes in the structure of the debt were more than obvious. While external debt grew primarily as a result of the debt of enterprises during the previous period, this trend reversed after the escalation of the crisis in the global financial system last year. At the same time, possibilities for government borrowing became fairly limited. Under these circumstances, domestic banks were the only ones that could borrow abroad and contribute to the stability of the domestic financial system. This was supported by the CNB's decision to remove the marginal reserve requirement. More difficult access to and the higher price of external capital will result in weaker external debt growth this year, with a likely continuation of changes in its structure. External debt in the corporate sector will probably decrease considerably in 2009 due to a high degree of risk aversion among investors and the fact that a substantial share of debt is related to short-term liabilities. At the same time, the government plans to borrow abroad during the first half of this year, which will open up more space for private sector borrowing in the domestic market. Domestic banks' foreign liabilities are expected to continue growing.

Adjustments
or is it enough?

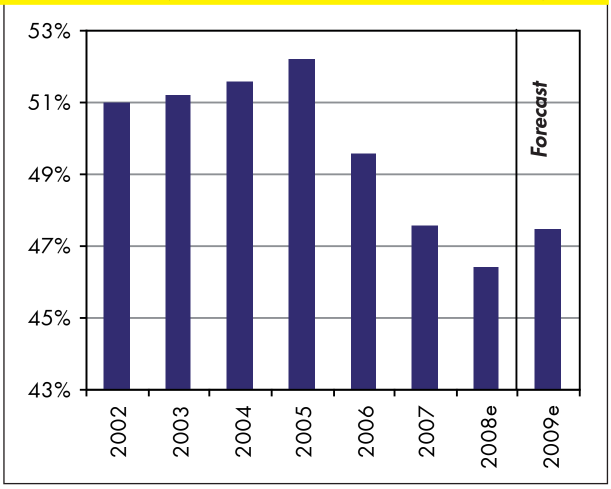
In circumstances where the inflow of foreign capital is limited, fiscal authorities in countries with large external imbalances are not able to run a more expansive fiscal policy. As a result, efforts in Croatia are mostly aimed at limiting expenditure growth, which should contribute to a smaller current transactions deficit. The tax burden is unlikely to be reduced without a previous reduction in expenditures. Following a long period of relatively strong budget revenue growth as a result of dynamic economic activity, reduced tax evasion and the influence of stronger inflationary pressures, Croatia experienced a slowdown in budget revenues at the end of last year. In light of the likely decrease in budgetary revenues this year, we believe there is a need for budget restructuring. The process of restructuring itself pointed out the inability of the fiscal authorities to adapt to the current situation, which was the result of the unfavourable structure and scope of public expenditures, in a prompt and efficient manner. The budget restructuring mostly lays out a reduction in the scope of expenditures, while there were no major changes in the structure of expenditures. During the budget restructuring process, there was a lively discussion regarding the salaries of public sector employees. On the one hand, the government needs to cut down its current expenses and the growth bill was larger than the increase in the efficiency of public services over the past year. On the other hand, the salaries of public sector employees are inappropriately low. This claim is substantiated by the fact that there is a lack of expert healthcare workers, which could be further aggravated by the outflow of workers upon Croatia's accession to the EU. Public administration reform is the only long-term solution to this problem. Such reform would reduce the number of staff and increase efficiency, thus ensuring salary growth. In the current situation, where there is a high degree of uncertainty with regard to the global economy, we cannot rule out the need for another budget restructuring, especially if the decline in the budgetary deficit is larger than expected. In addition, we might see a larger-than-expected budget deficit. Apart from this short-term risk for the fulfilment of this year's budget plan, there are still certain risks that jeopardise the long-term stability of the fiscal system, primarily the likely upward trend in expenditures for pension and healthcare per employee as a result of unfavourable demographic trends (decline in the work force). If the government opts to cooperate with the IMF, even as a precaution, it is likely that the budget will have to be adjusted, especially on the expenditure side, and that there will be impetus for further structural reforms.

General government expenditures



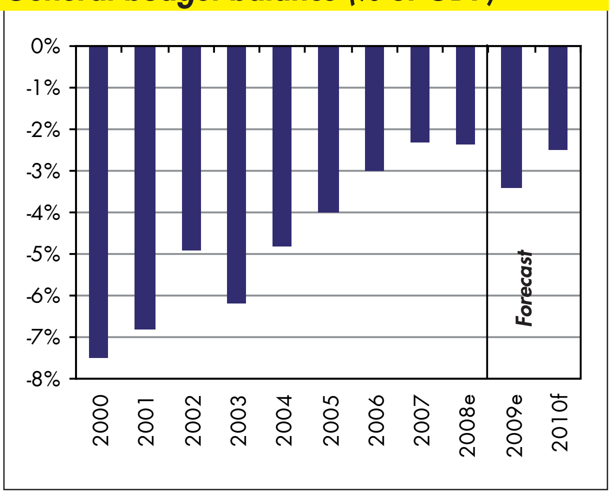
Source: MoF, Raiffeisen RESEARCH

Public debt (incl. HBOR debt, % of GDP)



Source: MoF, Raiffeisen RESEARCH

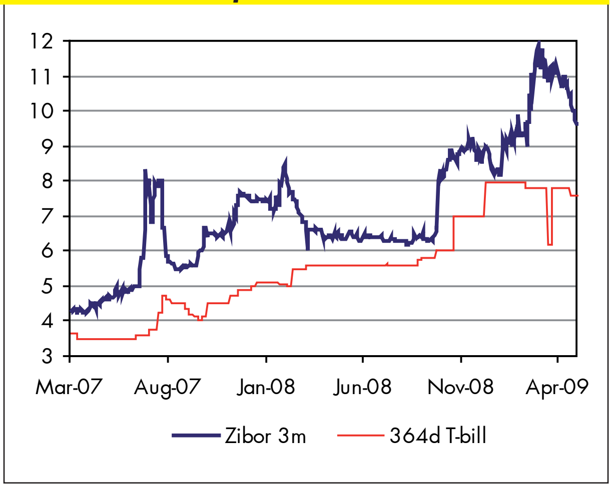
General budget balance (% of GDP)



Source: MoF, Raiffeisen RESEARCH

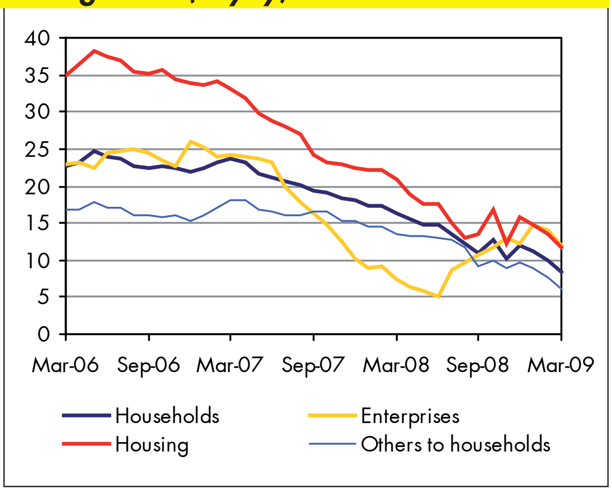
Period of high volatility
and interest rates

Interest rates (% p.a.)



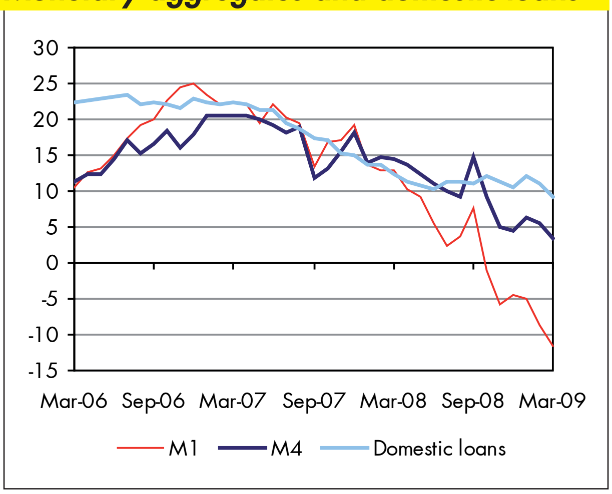
Sources: reuters.hr, CNB, MoF

Loan growth (% yoy)



Source: CNB

Monetary aggregates and domestic loans*



** % yoy*
Source: CNB

So far this year, developments on the domestic money market have been influenced by trends on the foreign exchange market because the interest differential was used as the primary instrument in safeguarding the stability of the domestic currency in the observed period. Kuna liquidity decreased in the first quarter primarily due to a decrease in activity on the part of the central bank in reverse repo auctions and foreign interventions, i.e. the sale of euros to banks. At the same time, the system was also characterised by a high level of structural illiquidity, and borrowing by the central government was intense, with extra-budgetary funds being borrowed on the domestic capital markets through T-bill auctions and credit arrangements with domestic financial auctions. In these circumstances, it was hardly surprising to see interest rates rise to record highs at the beginning of March. In addition, banks used Lombard loans intensely to attain the required liquidity levels in the observed period, resulting in the Lombard rate becoming the benchmark interest rate on the market. By creating liquidity through Lombard loans, the CNB has the possibility of managing liquidity and consequently exchange rate movements on a daily basis. In the upcoming period, we expect volatility to remain high on the domestic money market and among interest rates. The intensity of pressures on the money market will continue to be primarily determined by the strength of the downward pressure on the kuna, but also by the level of this year's budget deficit.

At the beginning of this year the trend of an annual decrease in the money supply continued, primarily due to a dramatic decrease in demand deposits. In addition, there was also a noticeable slowdown in cash in circulation, which was a result of slowed economic activity. Considering the level of (il)liquidity in the economy, the monetary aggregate M1 is likely to continue declining this year. Despite the reduction in the money supply, the broadest monetary aggregate, M4, went up at the beginning of 2009 primarily due to the growth of foreign exchange deposits. The largest contribution to the growth of deposits came from high deposit rates, which now exceed negative influences on savings such as less available household income and deteriorating liquidity in the economy. Later this year, we expect deposits and the M4 aggregate to continue growing, but at a significantly slower pace than over the last year.

What will happen in autumn?

As expected, the beginning of this year brought about considerable challenges for the stability of the domestic currency. Traditionally, there is stronger demand for foreign currency from the corporate sector in the first quarter primarily as a result of the need to pay for increased import activity at the end of the previous year. This year, however, corporate sector demand increased even more than usual as a result of foreign liabilities falling due, and all this came under the condition of reduced inflow of foreign currency on the domestic market. Furthermore, increased regional risks resulted in stronger demand for euros from institutional investors. Under such circumstances, the decline in kuna savings, which consequently led to a reduction in kuna lending by domestic banks, is hardly surprising. When defining its goals in this turbulent year, the CNB decided that maintaining the stability of the domestic currency was its top priority and as a result the kuna registered the lowest decline in value against the euro among all currencies in the region. The central bank was forced to react and sell over a half a billion euros to banks via foreign exchange interventions. However, these movements depleted Croatia's international reserves, which in turn increased risk perception with regard to the foreign exchange solvency of the country and negatively affected its credit ratings. Therefore, the central bank decided to lower depreciation pressures primarily through a dramatic reduction in kuna liquidity and the release of foreign reserves. The market EUR/HRK exchange rate thus stabilised at HRK 7.50 per euro, which proved to be a solid resistance point against further exchange rate growth.

In contrast to previous years, when the most important influence on the foreign exchange market came from the inflow of foreign capital (e.g. last year's INA takeover) and increased demand for the kuna (e.g. HT's IPO), the key influence this year will come from developments in the balance of payments current account. As a result, in the second and third quarters of this year, we expect to see depreciation pressures on the kuna, but they will be less intense due to the inflow of foreign currency from tourism. In addition to the success of the tourism season, much will depend on the success of the announced Eurobond issue in the observed period. Croatia has achieved one of the lowest trade deficits over the last few years, primarily as a result of reduced imports, which contributed to less depreciation pressure on the kuna. Somewhat more pronounced upward pressure on the EUR/HRK kuna exchange rate can be expected in autumn, but the intensity of this pressure will depend on the situation on the regional and international financial markets.

Middle exchange rate of the CNB

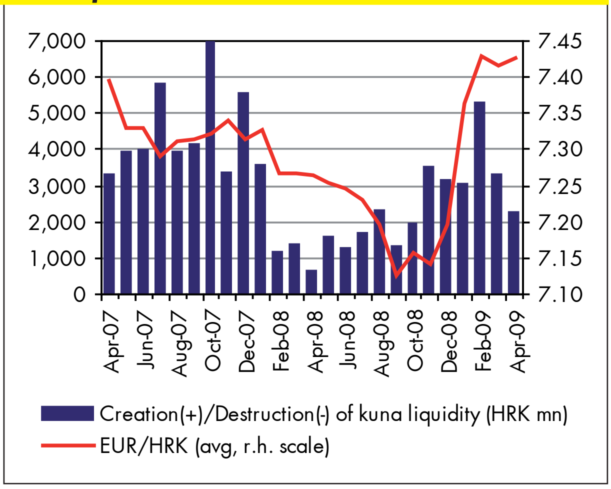
Source: CNB

Middle exchange rate of the CNB

	Middle exchange rate	Change compared to: 31 Dec-08		
Currency	30 Apr-09	Exch. rate	Movements	%
EUR	7.4251	7.3244	↑	1.81
USD	5.6102	5.1555	↑	9.79
CHF	4.9323	4.9111	↑	0.20
GBP	8.2833	7.4846	↑	7.09

Source: CNB

CNB operations and FX movements



Source: CNB

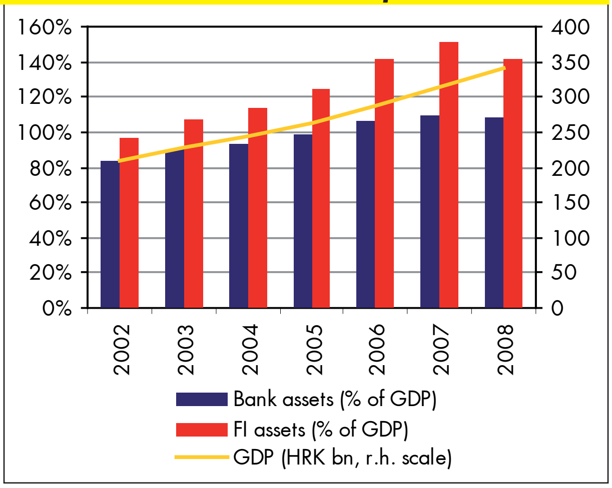
Exchange rate forecast

	actual	Sep-09	Dec-09	Mar-10
EUR/HRK	7.30	7.50	7.65	7.65
USD/HRK	5.21	5.17	5.10	5.10
EUR/USD	1.40	1.45	1.50	1.50

Source: Reuters, Raiffeisen RESEARCH

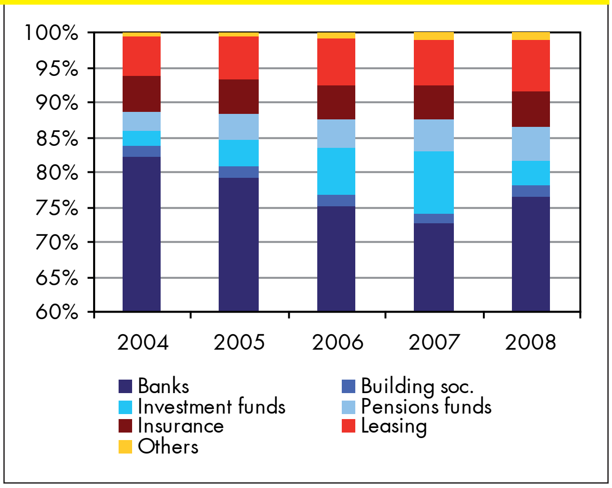
Stable financial system

Financial institutions development



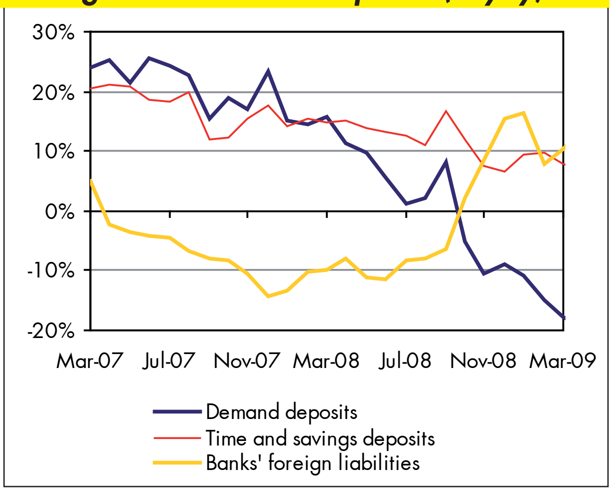
Source: CNB, CFSSA

Croatian financial sector structure



Source: CNB, CFSSA

Foreign liabilities and deposits (% yoy)



Source: CNB

In just one year's time, the assets of open-end investment funds fell by 67%, whereby the assets of publicly offered equity funds decreased by over 80%. The flight of investors from the capital market to safer investments contributed to the size of deposits and thus increased the contribution of banks to the total assets of the financial sector. Banks reclaimed a share of 75%, and compulsory pension funds are the only other type of financial institution whose assets have positive growth prospects in the conditions of decreasing GDP and employment.

In 2009, the CNB loosened its limitations on bank operations. The coefficient of the minimum coverage of foreign exchange liabilities with short-term claims was reduced twice in February, from 28.5% to 25%, and then to 20%. This released the previously frozen liquid bank assets, providing for additional lending and enabling the monetary authorities to maintain the exchange rate stability. The first reduction in liabilities was targeted at lending to the government and was used for the repayment of the government's obligations that are due abroad, and the second reduction was made available to banks to increase their lending potential. Since banks will use a share of the released assets to clause expensive money market loans, we do not expect the slowdown in bank placement growth to stop. This is primarily related to lending to households, where the year-on-year growth rate decreased to 10% with a declining tendency, and the growth rate of loans to enterprises, which stabilised at around 15%. Paired with the expected low inflation, the annual nominal growth rate of total loans is not expected to exceed 10%.

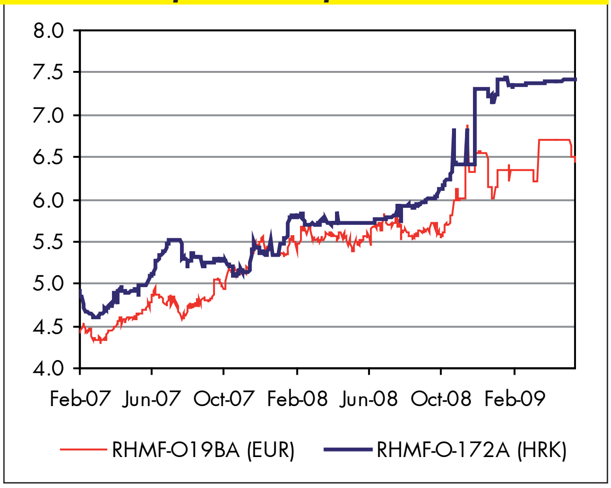
The total assets of investment funds fell to HRK 10 bn in February. The level of assets in money market funds is being maintained for the time being, primarily due to the attractive available returns. However, future investors in these funds will come predominantly from enterprises and their investments simultaneously reduce the amount of money deposited by enterprises with banks. A shortage in deposits would drive banks to borrow additional funds, but this trend is not sustainable in the long term. We expect even more competition to attract domestic deposits and consequently put upward pressure on deposit rates. This further reduces the attractiveness of alternative forms of investment, which leads to a further marginalisation of other financial investments. This means that banks will continue to increase their share in total financial sector assets.

An increase in supply
is of key importance

After record-low yields on government debt of the world's most developed countries in the final months of last year, the first quarter of this year was dominated by strong upward pressures on yields. A decline in the prices of government bonds in the US and the euro area was primarily a consequence of exceptionally expansive fiscal policy, i.e. an increase in the supply of government debt. This fiscal year is expected to see a record-high budget deficit in the US, primarily as a result of the high cost of anti-recessionary measures and the rescue of financial institutions. The growth of yields was very pronounced at the longer end of the curve due to an increase in fears on the market related to the long-term influence of the expansive monetary and fiscal policy in the US on price levels and the value of the dollar.

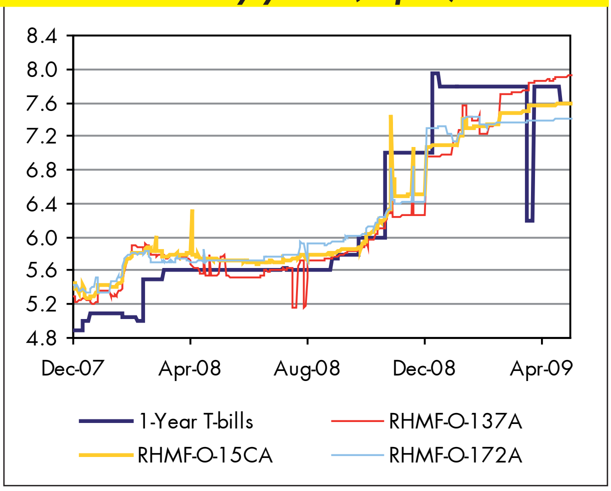
In addition, euro area members have also substantially increased their public expenditures to stimulate economic activity. The yield curve for the bund also registered an increase in its slope amid expectations of more aggressive moves from the ECB. Furthermore, this resulted in the continued widening of spreads on the bund and government bonds of other euro area members as some of the observed countries experienced credit rating downgrades. Nevertheless, yield growth was mitigated in the observed period by the continuation of unfavourable announcements from the US and the euro area, which raised investor concerns with regard to the state of the global economy. In addition, the US saw the highest daily growth in prices of government bonds in the past few decades following the Fed's decision to purchase debt securities, including government bonds, for the purpose of influencing long-term interest rates. By the end of this year, an increased supply of government debt, paired with a recovery in economic activity and renewed confidence in the financial system, should lead to further yield growth for US and German bonds. At the same time, due to the strong slowdown experienced by the CEE and SEE economies, the prices of financial assets in the observed countries were under substantial pressure. Continued strong risk aversion among investors led to a further dramatic decline in the prices of government bonds, with strong depreciation pressures and credit rating downgrades contributing to this trend. Under these circumstances, it is not surprising that the IMF is playing an increasing role in the region. Countries in the region are faced with an increased need for borrowing as economic activity, and consequently budget revenues, decrease, which is contributing to the rise in yields. With growing political risks, there

Yield developments (% p.a.)



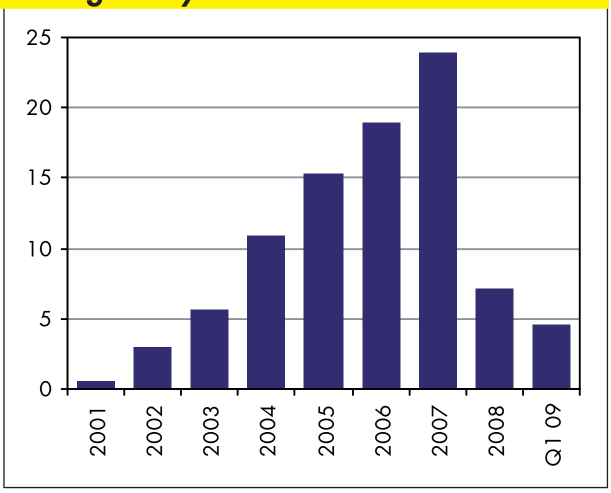
Source: Reuters, Raiffeisen RESEARCH

Domestic currency yields (% p.a.)



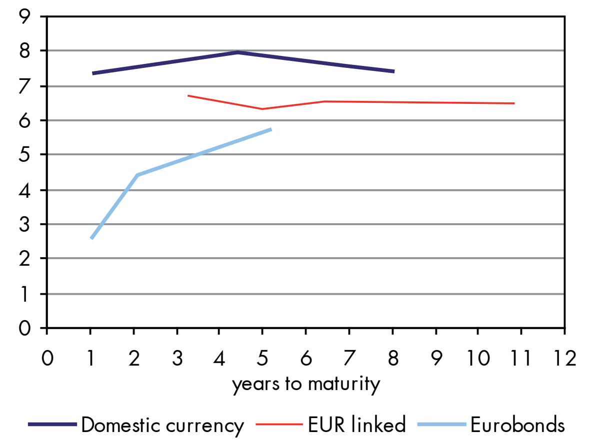
Source: MoF, Reuters, Raiffeisen RESEARCH

Average daily turnover of domestic bonds*



** EUR mn*
Source: ZSE

Yield curves of Croatian bonds (% p.a.)



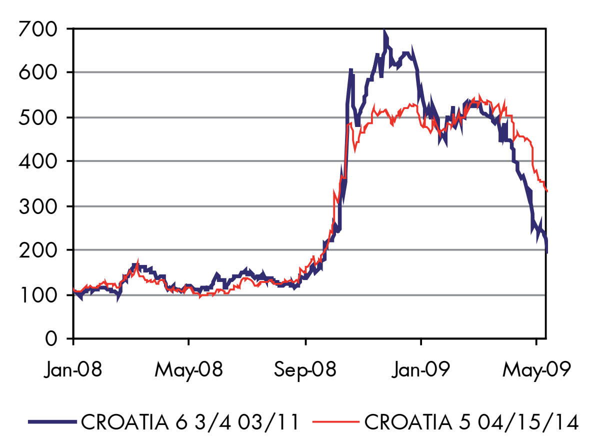
Source: Reuters, Raiffeisen RESEARCH

Government bonds in domestic market

Bond	Currency	Volume (mn)	Maturity	Coupon (%)	YtM (ask, %) 20/05/09
RHMF-O-125A	EUR*	500	23/05/12	6.875	6.32
RHMF-O-142A	EUR*	650	10/02/14	5.500	6.32
RHMF-O-157A	EUR*	350	14/07/15	4.250	6.56
RHMF-O-19BA	EUR*	500	29/11/19	5.375	6.50
RHMF-O-103A	HRK	3,000	08/03/10	6.750	7.40
RHMF-O-137A	HRK	4,000	11/07/13	4.500	7.97
RHMF-O-15CA	HRK	5,500	15/12/15	5.250	7.61
RHMF-O-172A	HRK	5,500	08/02/17	4.750	7.43

** indexed to euro; secondary trading, interest and principal payment mid rate of CNB on trading day or maturity day*
Source: MoF, ZSE, CDA, Reuters

Croatian Eurobond spreads (bp)



Source: Bloomberg, MoF, Raiffeisen RESEARCH

are still many unknowns with regard to the final influence of the current crisis on the economies in the region, which is preventing yield corrections despite a certain level of improvement in the sentiment among global investors.

The beginning of this year saw a continuation of unfavourable movements on the domestic bond market. First quarter trading was characterised by the further weakening of investor activity paired with the decline in prices of domestic issues. In the observed period, total bond turnover reached some HRK 1.58 bn, which is only about 26% of the turnover realised in the first three months of last year. At the same time, the most significant portion of the turnover was accounted for by government bonds indexed to foreign currency. In comparison with the end of 2008, we registered higher yields, as well as an increase in yields for German benchmark bonds. Low liquidity remained the most significant factor on the domestic bond market. Under these conditions, increased short-term government borrowing is contributing to weaker demand for bonds. Institutional investors prefer short-term investments due to increased risks and reduced liquidity, and the current T-bill yields are attractive. By the end of May 2009 Croatia issued its first Eurobond since 2004. The expected volume of EUR 750 mn was reached, but the deal attracted commitments of about EUR 1.25 bn. The issue was priced at 360bp over mid-swap (a 6.582% yield), with a maturity in January 2015. Although this issue might be seen as a successful return to the foreign capital markets, it is clear that the government will have higher financing needs for this year. We believe that the government might try to place an additional issue later in the year. In addition to its significant influence on the entire financial system (interest rate levels, exchange rates), it will also define the degree of risk for Croatia. The last Eurobond issue dates back to 2004 as a result of the government's decision to borrow in the domestic capital market. Although CDS movements clearly indicate a rising trend in borrowing costs for Croatia and other countries in the region, this indicator should be taken with a grain of salt due to the relatively low liquidity of the observed market. It would be hard to expect a more substantial recovery of the prices of government debt in the upcoming period, and prices will certainly not return to the levels attained in the first half of 2007. In addition, we cannot rule out another downgrade in the country's credit rating in line with developments in the region.

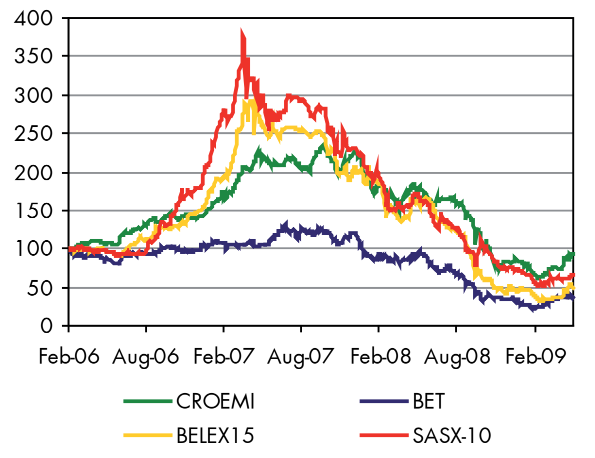
Local currency debt instruments

Description	**Treasury bills**	**Treasury bonds**	**Corporate bonds**	**Municipal bonds**
Issuer	Ministry of Finance	Ministry of Finance	Big local banks, companies	Municipal governments
Currency	Croatian Kuna (HRK) and Euro-linked issues settled in HRK	Croatian Kuna (HRK) and Euro-linked issues settled in HRK	Croatian Kuna (HRK) and Euro-linked issues settled in HRK	Croatian Kuna (HRK) and Euro-linked issues settled in HRK
Settlement currency	HRK; for Euro-linked in HRK according to CNB mid-rate for EUR/HRK	HRK; for Euro-linked in HRK according to CNB mid-rate for EUR/HRK	HRK; for Euro-linked in HRK according to CNB mid-rate for EUR/HRK	HRK; for Euro-linked in HRK according to CNB mid-rate for EUR/HRK
Minimum denomination	100 000	1	1	1
Tenor(s)	3-24 months	4-8 years; Euro-linked 3-10 years. Eurobonds 2-5years	2-9 years; Euro-linked 2-8 years	7-10 years
Interest rate/coupon	zero coupon (discount)	HRK 4.500% - 6.750%; Euro-linked 4.25% - 6.875%,Euro-bonds 4.625%-6.75%	4.125% - 8.500%; Euro-linked 4.500% - 6.500%	4.125% - 6.500%
Coupon payment dates	none	semi-annual; annual	semi-annual; annual	semi-annual
Interest accrual basis	365 days	365 days	365 days	365 days
Day count basis	actual/365	actual/actual	actual/actual	actual/actual
Amortization schedule	bullet	bullet	bullet	bullet
Form of issue	dematerialised	dematerialised	dematerialised	dematerialised
Total outstanding at face	HRK 13.9 bn EUR 569 mn	HRK 18 bn and EUR 2 bn (domestic) EUR 1.75 bn (Eurobonds)	HRK 2.21 bn and EUR 324.5 mn	HRK 60 mn and EUR 38.9 mn
Primary market				
Auction style	American style	Fixed price	Fixed price	Fixed price
Agent	Ministry of Finance	Domestic banks market-making govi debt	Domestic banks	Domestic banks
Average issue size	HRK 200 - 400 mn	HRK 2-3 bn and EUR 400 mn	HRK 100 - 500 mn and EUR 20 mn	n.a.
Frequency	weekly	irregular	irregular	irregular
Participation	only domestic legal entities	via Govi market-makers	via appointed primary place-ment bank	via appointed primary place-ment bank
Settlement	T+2	T+3	T+3	T+3
Reuters/Bloomberg screens	HR/DEBT -> <MFHT> / n.a.	n.a. / <CROATE Govt>	n.a.	n.a.
Secondary market				
Trading floor(s)	interbank market	ZSE	ZSE	ZSE
Liquidity	5 mn	HRK 30 mn and EUR 10 mn	HRK 5 mn and EUR 0.5 mn	n.a.
Settlement	T+0 *; T+2	T+3	T+3	T+3
Average trade size	1 mn	HRK 4 mn and EUR 1 mn	HRK 1 mn and EUR 0.1 mn	n.a.
Clearing mechanism	CDCC (Central Depository & Clearing Company)	CDCC	CDCC	CDCC
Custody	CDCC	CDCC	CDCC	CDCC
Trading hours	08:30 am - 04:30 pm	10:00 am - 04:00 pm	10:00 am - 04:00 pm	10:00 am - 04:00 pm
Reuters/Bloomberg screens	<0#HRTSY=> / <CROTB Govt>	<0#HRTSY=ZA> <HR/ CONT>/ <CROATE Govt>	<#HRCORP=ZA> / <Issuer name or ticker Corp>	<#HRMUNI=ZA> / <Issuer name or ticker Muni>
Regulation / taxes				
Restrictions on foreign investment	not allowed to invest	no restrictions	no restrictions	no restrictions
Income tax (for retail)	tax exempt	tax exempt	tax exempt	tax exempt
Income (coupon) tax	tax exempt	tax exempt	tax exempt	tax exempt
Capital gains tax **	tax exempt	tax exempt	tax exempt	tax exempt

ZSE - Zagreb Stock Exchange
** T+0 apllies to local banks only; ** Non-residents can obtain a tax relief subject to double taxation treaty, no taxes are levied on investments into debt securities, retail and non-residents investors do not pay Croatian local taxes, however, local companies and banks pay corporate tax; non residents are subject to taxation of their country of residence/incorporation*
Source: Ministry of Finance, National Bank, Raiffeisen RESEARCH

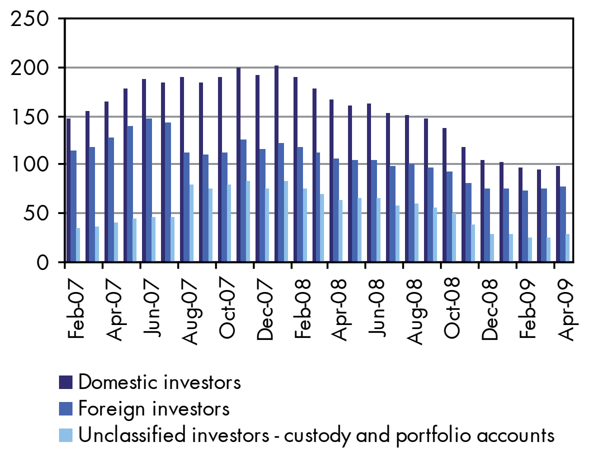
Croatian equity market
dependent on international markets

SEE equity market indices



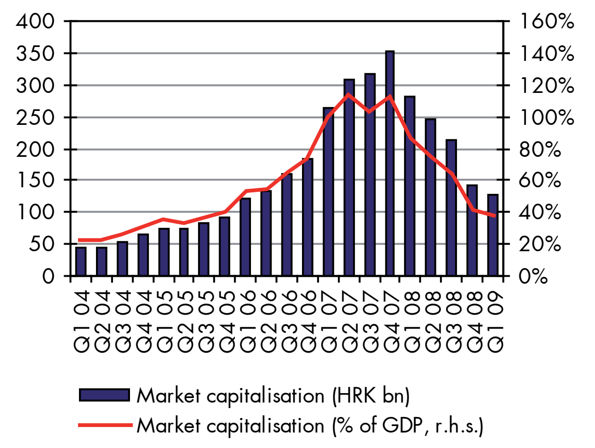
Source: Bloomberg, Raiffeisen RESEARCH

Holdings in stocks (in HRK bn)



Source: CDCC (www.skdd.hr), Raiffeisen RESEARCH

Market capitalisation ZSE



Sources: Zagreb Stock Exchange, Raiffeisen RESEARCH

The stock exchanges in Eastern and Southeastern Europe experienced even stronger turbulences than the established equity markets in 2008, and the Zagreb Stock Exchange was no exception. The liquidity crisis and subsequent economic crisis made investors far less willing to accept risk and led to the widespread selling of Croatian stocks. In addition, Croatian stocks were valued relatively highly in international comparison after prices had skyrocketed over the past few years. However, the outflow of capital from the Zagreb Stock Exchange appears to have started losing momentum in March. After briefly trading at a five-year low, the ***CROEMI stock index*** has recently seen a substantial recovery.

The chart shows that the Zagreb Stock Exchange saw foreign investors pulling their capital out in 2008. As a result, the ***share*** of stocks held by ***foreign investors*** – measured in terms of market capitalisation – further decreased last year. This can primarily be attributed to the negative global sentiment and the continued assessment of the Croatian equity market as a high-risk market. While the share of stocks held by foreign investors has increased by 5% to 38% over the last six months, the stock exchange is still suffering from lower ***trading volumes***. On one hand, the lack of liquidity is making potential new investors reluctant to invest in Croatian stocks. On the other, the tightness on the Zagreb Stock Exchange opens up certain opportunities to earn above-average profits even in bullish market phases because even small capital injections allow for significant price gains.

In the course of the worldwide skid on the equity markets, the ***market capitalisation*** of the Zagreb Stock Exchange also suffered a dramatic decline last year, falling by around 62% to HRK 138 bn in line with the development of prices. As a result of the unfavourable overall conditions on the financial markets, no noteworthy companies registered new listings on the Zagreb Stock Exchange last year. Despite the increased need for additional capital, the privatisation process is not expected to resume in 2009 due to low pricing on the equity markets, which makes such moves unpopular. This is primarily a result of negative sentiment on the equity market and the indifference being demonstrated by investors.

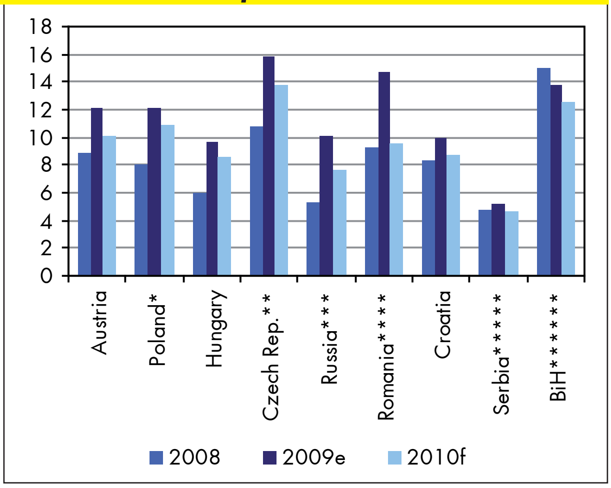
The global equity markets started creeping back up at the beginning of March. The recent ***improvement in sentiment*** is based on the positive news coming out of the global financial sector and the fact that the leading economic indicators in the US are stabilising, suggesting that an end to the recession is in sight. Thus, we believe that the economic crisis will reach its low point by the end of 2009 and that the equity markets will start to anticipate a recovery in 2010 starting this year already (on a global basis).

We believe that the ***Croatian equity market*** will also be pushed upwards in the course of a worldwide ***recovery***. However, this is unlikely to be a one-way street to the top, as the global recession has now reached Croatia as well (retail sales saw a real decline of 17.4% yoy in March; foreign direct investments have decreased by around 20% compared to last year; we are projecting a 4.5% decline in GDP for 2009), which leads us to believe that the Zagreb Stock Exchange will experience a high level of volatility throughout the second half of the year.

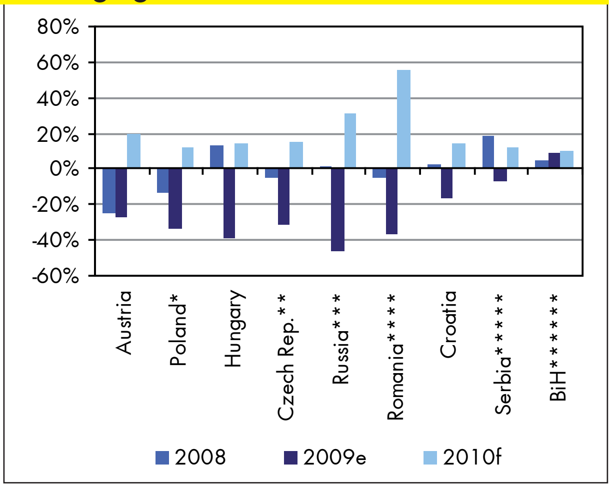
While annual accounts for 2008 came in very positive (most companies included in the CROEMI posted significant increases in both turnover and net profits), the ***outlook*** for the current year is not as good. ***Aggregate profits for the companies in the CROEMI*** are expected to ***decline by 16.2%***, which corresponds to a valuation of 10.4 for 2009. Nevertheless, ***decreasing risk aversion*** will likely lead to renewed investment activity in the previous growth markets of Eastern Europe, which will again experience above-average growth after the crisis due to the potential for economic convergence.

We are ***optimistic*** about the development of the Croatian equity market ***over the next twelve months.*** Investors with an eye for the long term will be able to use possible reversals over the summer to enter a market that, while risky, offers ample opportunities. In the course of an improvement of conditions on the capital markets, individual companies will once again register new listings on the stock exchange starting next year, which will result in new investment possibilities. In addition to domestic and foreign investment funds and local pension funds, private investors will increasingly provide positive stimulus.

P/E ratios in comparison



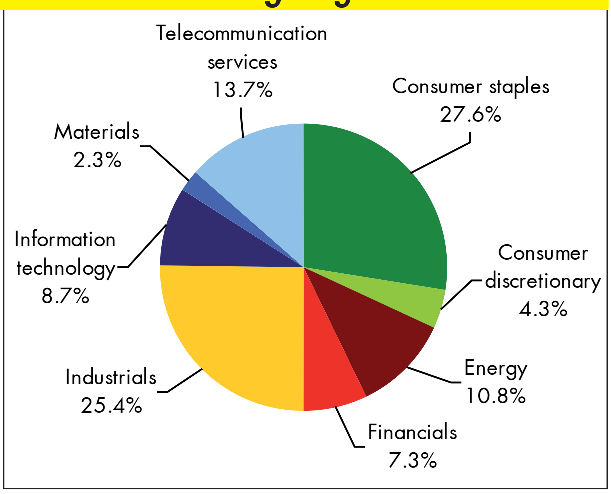
Earnings growth



** Poland (WIG 20): excl. CEZ; ** Czech Rep. (PX): excl. Erste Bank and ECM Real Estate; *** Russia (RTSI): VTB Bank; **** Romania (BET): excl. Azomures, Biofarm and SSIF Broker; ***** Serbia (BELEX 15): excl. Alfa Plam, Bambi, Imlek and Metals Banka; ****** BiH (SASX-10): excl. Energopetrol and Sipad*

Source: Thomson Financial Datastream, IBES, Raiffeisen RESEARCH

CROEMI sector weightings



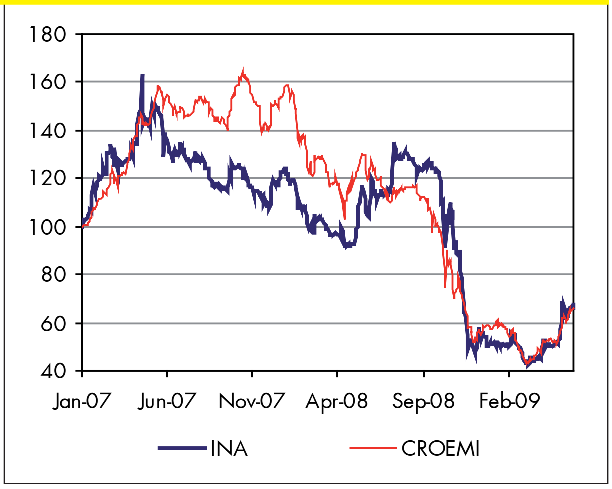
Source: Bloomberg, Raiffeisen RESEARCH

Croatian equities
a brief overview

Atlantic Grupa

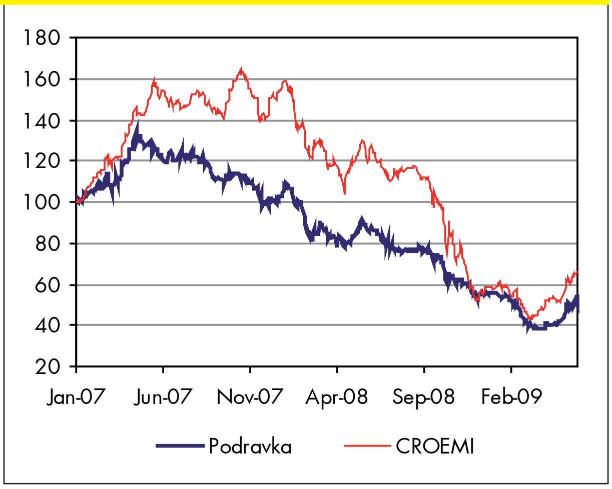
Source: Bloomberg

INA



Source: Bloomberg

Podravka



Source: Bloomberg

Atlantic Grupa

The group operates in four divisions: Distribution (of a number of popular international brands), Consumer Healthcare, Sports and Functional Food and Pharma (mainly OTC drugs and a chain of pharmacies). The results posted in Q1 2009 show that sales were up 12.5% yoy due to new contracts with principals, the introduction of new products in distribution and the acquisition of pharmacies. The group's operating and net profits and margins were significantly improved on annual basis. For FY 2009, management expects single-digit sales growth. Additional cost cutting measures are expected to yield net earnings growth somewhere above 10% yoy. The group plans to expand its distribution portfolio and open new pharmacies and specialised stores.

INA

This oil and gas company, in which a 47.2% stake is held by MOL and a 44.8% stake by the Croatian government, is going through a restructuring process, a change in management and statutory changes after MOL increased its stake. Following the annual general meeting scheduled for 10 June, the new supervisory board will comprise five members appointed by MOL and three representatives of the Croatian government, while the new CEO and half of the management board members will be appointed by MOL. The unprofitable gas segment is expected to be restructured by July 2009. The FY 2009 results are expected to show a recovery after the elimination of the price cap and sale of the gas segment. INA expects positive results from its refinery modernisation programme and growing production rates from the upgrading of oil fields by 2010.

Podravka

The company and its subsidiaries are manufacturers of a wide range of foodstuffs and non-alcoholic beverages, pharmaceuticals and cosmetic products. After the new management was appointed in August 2008, the annual results showed improvements primarily at the operating level, with EBIT of HRK 158.5 mn (+72% yoy). Net income grew from HRK 18.3 mn in FY 2007 to HRK 44.4 mn in FY 2008. Q1 2009 results showed improvement at the operating level, but a 300% increase in net financial expenses resulted in 61% lower net income. We also expect sales growth and savings in operating performance to be cancelled out by large financial expenses in FY 2009. However, the company has lots of room for improvements which we expect to start seeing after 2009.

Ericsson Nikola Tesla

The company provides modern telecommunications products, solutions and services related to landline communications, mobile communications and the Internet and also develops software. In Q1 2009, the company's top line figure was down 21% yoy due to a slowdown in operators' investments, especially in export markets. The deterioration of operating profitability was a result of a 10% yoy increase in staff expenses. Finally, the bottom line was almost doubled due to favourable exchange rate movements. The CIS region's share in Ericsson NT's sales structure has been decreasing over the past few years, and this trend is expected to continue in the future. On the other hand, mobile and broadband penetration rates are still low in Bosnia and Herzegovina and Kosovo, so we believe these markets will be the key growth drivers in the coming years.

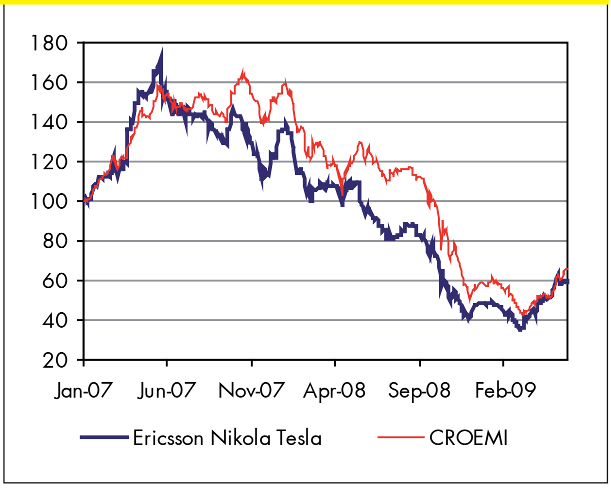
Petrokemija

The company mainly produces mineral fertilisers, but also makes carbon black and clay-based products. The majority stake in the company is held by the Croatian government. The reported Q1 2009 figures showed sales of HRK 592 mn (+20% yoy), a greatly improved EBITDA of HRK 40.9 mn (Q1 2008: HRK -9.2 mn) as well as net income of HRK 3 mn (Q1 2008 saw a net loss of HRK 28.7 mn). The fertilisers market is currently experiencing a downtrend and is highly dependent on food and energy prices. The company is exposed to changes in the price and availability of gas, USD and EUR FX risk, increases in oil prices and environmental risk. For the current year, the company estimates net income of HRK 9.7 mn (FY 2008: HRK 56.4 mn) as a result of the challenging business environment.

Tankerska Plovidba

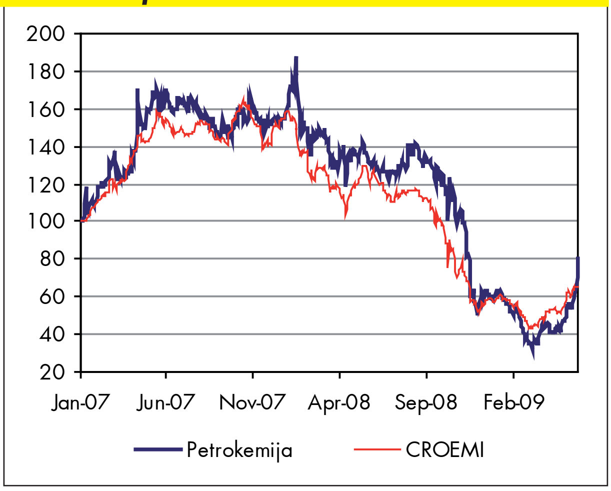
The company currently owns ten crude oil carriers with a total capacity of 1,230,445 SDWT and six dry bulk carriers with a total capacity of 180,460 SDWT and is the largest Croatian shipping company. During Q1 2009, the company achieved sales of HRK 255 mn (+10.2% yoy), but operating and net profits and the corresponding margins were down 50% from the figures reported in Q1 2008. The risk involved in running the company is mainly related to changes in freight rates and USD FX risk. Currently, shipping is diving at the bottom of the cycle and is feeling the effects of the recession. However, crude oil shipping is more resilient than dry bulk, but is subject to available global fleet capacity. Management plans to increase the fleet to 24 ships with a total capacity of 1.7 million SDWT.

Ericsson Nikola Tesla



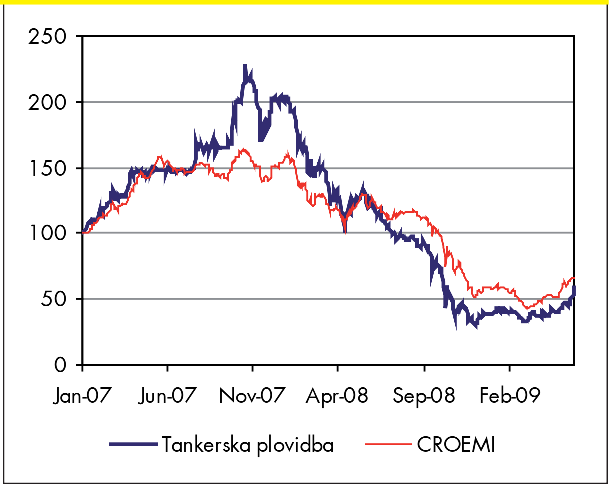
Source: Bloomberg

Petrokemija



Source: Bloomberg

Tankerska Plovidba



Source: Bloomberg

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Abbreviations

Currencies and Countries

ALL	Albanian lek
BAM	Bosnian marka
BGN	Bulgarian lev
BYR	Belarusion Rubel
CNY	Chinese yuan
CZK	Czech koruna
EKK	Estonian kroon
HUF	Hungarian forint
HRK	Croatian kuna
LTL	Lithuanian litas
LVL	Latvian lats
PLN	Polish zloty
RON	Romanian leu
RSD	Serbian dinar
RUB	Russian rouble
SIT	Slovenian tolar
SKK	Slovak koruna
TRY	Turkish lira
UAH	Ukrainian hryvnia

Economic abbreviations

%-chg	Percentage change (not in percentage points)
avg	average
bp	basis points
C/A	Current Account
CPI	Consumer Price Index
FDI	Foreign Direct Investments
FX	Foreign Exchange
GDP	Gross Domestic Product
LCY	Local Currency
mom	month on month
pp	percentage points
PPI	Producer Price Index
T/B	Trade Balance
ULC	Unit Labour Costs
yoy	year on year
e	estimate
f	forecast

Stock Exchange Indices

BET	Romanian stock index
BUX	Hungarian stock index
CROEMI	Croatian stock index
PX	Czech stock index
RTSI	Russian stock index
WIG 20	Polish stock index

Equity related

DY	Dividend yield
EG	Earnings growth
LTG	Long term (earnings) growth
P/E	Price earnings ratio
RS	Recommendation suspended
UR	Under Revision

Publication related abbreviations

CBS	Croatian Bureau of Statistics
CES	Croatian Employment Service
CNB	Croatian National Bank
MoF	Ministry of Finance
MVPEI	Ministry of Foreign Affairs and European Integration
ZSE, VSE	Zagreb Stock Exchange, Varaždin Stock Exchange
HANFA, CFSSA	Croatian Agency for Supervision of Financial Services
ECB	European Central Bank
FED	Federal Reserve System
IMF	International Monetary Fund
WB	World Bank
OPEC	Organization of the Petroleum Exporting Countries
IEA	International Energy Agency

CE	Central European countries - Poland, Hungary, Czech Republic, Slovakia, Slovenia
SEE	South East European countries - Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia
CIS	European CIS (Commonwealth of Independent States) countries - Russia, Ukraine, Belarus
CEE	Central and Eastern Europe (CE + SEE + CIS)

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